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The Whys and Wherefores of Investment Letters

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THE WHYS AND WHEREFORES OF INVESTMENT LETTERS

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ONE of the more difficult problems under the Securities Act of 1933[1] relates to the private placement of stock. The basic purpose of the act is to protect the security buying public by means of stringent disclosure requirements.[2] Such disclosures are achieved through the filing of a registration statement with the Securities and Exchange Commission and the use of a prospectus in making the offering. If a security is sold in a public offering without the required registration statement and prospectus, the purchaser, at his option, may rescind the transaction or sue for damages in case of loss[3] so that, in effect, any seller making a public offering of unregistered stock is acting as a guarantor against loss at least during the one year statute of limitations. This is hardly an enviable position in which to find oneself.

Transactions "not involving a public offering" are specifically exempted from the registration and prospectus requirements.[4] To come within the scope of this exemption, the offering must be limited to a small number of persons and these persons must acquire the stock for investment and not for distribution.[5] If one purchaser among the group acquires stock with a view to a further distribution, he becomes a statutory "underwriter" and the exemption is then lost,[6] not only

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1. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1958) (Supp. II, 1959-1960).

2. 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1958).

3. "Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity. . . ." Securities Act of 1933 § 12(1), 48 Stat. 84, as amended, 15 U.S.C. § 77l (1958).

4. "The provisions of section 77e of this title shall not apply to any of the following transactions: (1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction). . . . (2) Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders." 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1958).

5. See, e.g., Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951).

6. "The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary

for himself, but probably also for his associates, who may have been completely ignorant of his intention.

To protect the seller and other participants in a private offering, it has been customary for each buyer to give a so-called "investment letter" which states in substance that he is acquiring the shares for investment and not for distribution. These investment letters have raised a host of problems and indeed are "hazards for the unwary."[7] When are they to be required? How meaningful are they? How long must the stock be retained? What is the effect of a premature resale?

These questions have become increasingly important in recent years[8] because of the expanded use of the investment letter technique as a means of raising equity capital from limited groups of selected investors. For some time after the enactment of the 1933 act private placements were largely confined to substantial institutional investors, such as insurance companies, and the securities were principally high grade corporate bonds. More recently, however, many new enterprises have resorted to private placements of equity securities, thus avoiding the registration requirements of the act. Presumably this is sometimes done to avoid the not inconsiderable expenses involved in registration procedures. Perhaps it is more often done because of the difficulty in consummating a successful public offering of highly speculative enterprises with their attendant risks and absence of earnings.

Institutional investors have substantial facilities in the form of research staffs or specially retained investment advisors with which to make a considered judgment on the merits or values of corporate obligations. Rarely, however, is the same true of the purchasers of speculative equities who are offered these securities under so-called investment letters. The question is then presented as to whether there is a bona fide exemption or whether there is, in effect, a distribution of the type which Congress believed should be accompanied by the information which normally would be made available through a full registration statement[9] and attendant prospectus.[10]

distributors' or sellers' commission." 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77b (11) (1958).

7. Victor & Bedrick, Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869 (1959). For extended discussions of various phases of private placement problems, see 1 Loss, Securities Regulation 689-96 (2d ed. 1961) (the leading treatise in this field); Cohen, Federal Legislation Affecting the Public Offering of Securities, 28 Geo. Wash. L. Rev. 119 (1959); Israels, Some Commercial Overtones of Private Placement, 45 Va. L. Rev. 851 (1959); Mendel, Institutional Investment Through Private Placement of Corporate Securities, 53 Colum. L. Rev. 804 (1953).

8. Such questions were among the most frequently posed at the Annual Securities Briefing Conference in Washington in June 1961.

9. 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1958).

10. 48 Stat. 81 (1933), as amended, 15 U.S.C. § 77j (1958).

WHEN DOES A TRANSACTION NOT INVOLVE A PUBLIC OFFERING

The term "public offering" is not defined in the statute or in any rules and regulations under the 1933 act. Within a few years of the enactment of the statute, however, an opinion of the General Counsel of the Securities and Exchange Commission was published[11] in which the various governing factors were set forth. It was made clear that the status of a particular transaction as a public offering was to be determined by a consideration of all the surrounding circumstances. Among the factors to be considered were: the number of offerees and their relationship to each other and to the offeror; the number of units offered; the size of the offering; and the manner of the offering. With respect to the number of offerees, it was stated that an offering to a limited number was less likely to be a public offering than an offering to a larger group. The view was expressed that an offering to twenty-five persons or less was presumably not a public offering. It is important, however, to note that no categorical statement was made on this point. An offering to a class having special knowledge and information of the issuer was less likely to be a public offering than one made to members of a class of the same size who did not have this knowledge. With respect to the number of units to be offered, an offering of units in small denominations might indicate an intention to make a public distribution while an offering of a small number of large units might indicate a contrary intention. As to the size of the offering, consideration was to be given to whether the security in question was a part of an issue already outstanding in the hands of the public, or whether it was a completely new issue. Concerning the manner of the offering, it was pointed out that transactions effected by direct negotiations with the issuer were more likely to be non-public than those effected through the machinery of public distribution.[12]

The criteria set forth above have generally been adopted by the courts, and a number of cases have been decided which afford reasonable guide posts in determining the character of an offering.[13] In the leading case of *SEC v. Ralston Purina Co.*,[14] however, the Supreme Court, in effect, added a newer and perhaps even determinative test—the availability to the offerees of information relative to the issuer. The Court stated that the term "public offering" might apply to either a large or small number of offerees, and that, while offerings to a substantial number of persons

11. SEC Securities Act Release No. 285, Jan. 24, 1935.

12. An exception cannot be made for a "portion" of a single offering, as all portions will be integrated into the whole. See 1 Loss, Securities Regulation 687 (2d ed. 1961).

13. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Collier v. Mikel Drilling Co., 183 F. Supp. 104 (D. Minn. 1958); SEC v. McBride, 143 F. Supp. 562 (M.D. Tenn. 1956).

14. 346 U.S. 119 (1953). This is the only case in which the Supreme Court has reviewed the question.

would rarely be exempt, there was no justification in placing a quantity limit on private offerings as a matter of statutory interpretation. The Court chose rather to interpret the private offering exemption "in light of the statutory purpose."[15] This purpose was whether the particular class of persons affected needed the protection of the act. While an offering to persons "shown to be able to fend for themselves" might be a transaction "not involving any public offering,"[16] the Court stated that "the focus of inquiry should be on the need of the offerees for the protections afforded by registration . . . ,"[17] and on the accessibility to them of information which registration would disclose.

The Court concluded that the four hundred employees of the company, to whom stock offerings were being made, were not shown to have had access to the information which registration would have disclosed, and accordingly held that an offering to them was not entitled to the exemption.[18]

How to Determine Intent Relative to Resale

Assuming that all the factors referred to above supported the conclusion that no public offering was made, it would still be necessary to show that the purchasers took for investment and not for distribution; for, indeed, if even a few purchasers acquired their shares with an intent to make a public distribution, these purchasers would under the statute become underwriters and thus lose the exemption under section 4(1).[19] An early opinion of the General Counsel of the Commission made it clear that the intent of the initial purchasers at the time of acquisition is essentially a question of fact and that the mere statement that a purchase was for investment is not necessarily conclusive. The opinion continued as follows:

> [T]here should be considered such other factors as: (1) the relation between the issuer and the initial purchaser; (2) the business of the latter, as for example, whether such purchaser is an underwriter or dealer in securities, and, if not, whether the purchase of such a block of securities for investment is consistent with its general operations; and (3) the length of time elapsing between the acquisition of the securities by the initial purchaser and the date of their proposed resale.
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> Of course, if the securities in question were in fact purchased by the initial purchaser for investment rather than for resale, dealers' sales thereof to the public would not necessitate registration under the Securities Act.
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> In conclusion, I feel that I should point out that even though a dealer is satisfied that a particular block of unregistered securities was bought by an initial purchaser

15. Id. at 125.

16. Ibid.

17. Id. at 127.

18. For extended discussion of the Ralston Purina case see 1 Loss, Securities Regulation 656-65 (2d ed. 1961) and cases cited.

19. 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1958).

for investment, he nevertheless takes the risk that, if his determination is incorrect, sales by him of such securities will be in violation of the registration requirements of the Act.[20]

The mere collection of so-called "investment letters" from a small group of purchasers will not save the exemption if those purchasers make a subsequent redistribution. Whether the transaction viewed as a whole amounts to a "public offering" will depend upon a consideration of all the facts and circumstances and not upon the number of signatures of the initial recipients of stock appearing at the end of investment letters. It is essential, therefore, that those concerned should know the identity and number of initial offerees and whether or not any original purchasers have sold or intend to resell their shares. The Commission pointed out in *Dempsey & Co.*[21] that if twenty-five persons were free to resell or reoffer their allotment to a further group of another twenty-five persons without registration, the so-called exempt offering to the original twenty-five persons would, as a result, be enlarged to an offering to 625 persons.

The first important cases to consider the question of original issuance and subsequent distribution were those arising out of the sale, in 1955 and 1956, of $4,000,000 in convertible debentures by Crowell-Collier Publishing Company through what was claimed to be a private financing, but which was found to have been, in fact, an unregistered public offering.[22]

In *Crowell-Collier Publishing Co.*,[23] a case involving a so-called private placement of convertible debentures, investment letters had been obtained from twenty-seven original purchasers of the debentures, dated August 10, 1955. The company had obtained an opinion of counsel that the private offering exemption could be relied upon in connection with the original offering if it were limited to twenty-five offerees. In May 1956, slightly less than a year later, a further distribution of some of these debentures was made. In the meantime, certain of the debentures had been converted into common stock. The subsequent purchasers of the debentures also gave letters containing investment representations. Counsel for the original purchasers gave written opinions in May and June 1956, at the time of the subsequent resale, that the resale of the debentures was exempt from the registration requirements of the Securities Act under section 4(1). Notwithstanding the limitation of the original offering and the receipt of investment letters, it developed that in fact there were seventy ultimate purchasers representing eighty-eight individuals and firms.

20. Op. Gen. Counsel, SEC Securities Act Release No. 603 (Class C) at 2, Dec. 16, 1935.

21. 38 S.E.C. 371 (1958).

22. See Fooshee and McCabe, Private Placements—Resale of Securities: The Crowell-Collier Case, 15 Bus. Law. 72 (1959); Note, 72 Harv. L. Rev. 784 (1959).

23. SEC Securities Act Release No. 3825, Aug. 12, 1957.

The Commission concluded that under the circumstances of the case, no exemption was available and that the sale of the debentures and the stock received on conversion violated the registration provisions of the act. It was stated that through these purported private offerings of debentures, the company accomplished what it could not do directly, that is, it obtained substantial additional capital from the sale to the public of equity securities which had not been registered so that the appropriate information required by the act was not given to the ultimate purchasers. The Commission further held that an issuer or an underwriter may not separate parts of a series of related transactions comprising an issue of securities and thereby seek to establish that a particular part is a private transaction if the whole involves a public offering.

It is important to note that in the *Crowell-Collier* case the Commission specifically stated:

> Counsel, issuers and underwriters who rely on investment representations of the character obtained in these transactions as a basis for a claim to a non-public offering exemption under Section 4(1) of the Securities Act do so at their peril. It is apparent that most of the persons giving the so-called "investment representation" in this case had no clear understanding as to what it meant. The representations apparently did not reveal the real intent of the persons giving them. The persons purporting to rely upon them did not know what the person giving the representation intended. Such bare representations that securities are being purchased for "investment," obscure in their meaning and unreliable as to the intention and purpose of a purchaser, are meaningless. An exemption under the provisions of Section 4(1) is available only when the transactions do not involve a public offering and is not gained by the formality of obtaining "investment representations."[24]

The *Crowell-Collier* matter eventually reached the United States Court of Appeals for the Second Circuit, and the order of the Commission was affirmed.[25] In his decision, Judge Lumbard, citing *SEC v. Ralston Purina Co.*,[26] pointed out that one claiming an exemption from section 5[27] for the sale of an unregistered security has the burden of proving that he comes within the exemption. The court also upheld the conclusion of the Commission that the mere holding for approximately a year with a sale based upon the subsequent change in the issuer's circumstances was not tantamount to purchasing for investment.

Involved in the *Crowell-Collier* situation were two related cases, *Gilligan, Will & Co.*[28] and *Dempsey & Co.*,[29] in which registered broker-dealers were suspended from the National Association of Security Deal-

24. Id. at 7.

25. Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), affirming 38 S.E.C. 388 (1958).

26. 346 U.S. 119 (1953), reversing 200 F.2d 85 (8th Cir. 1952).

27. 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e (1958).

28. 38 S.E.C. 388 (1958), aff'd, 267 F.2d 461 (2d Cir. 1959).

29. 38 S.E.C. 371 (1958).

ers because they had in substance acted as underwriters under the definition of the Securities Act. In these cases the Commission held that the purchasers of the debentures, who resold, were not justified in assuming, even in good faith, that the character of the financing as a private placement would not be changed by their own further sales for investment. Even the intent to make a subsequent sale to friends and associates was not considered as preserving the transaction from the status of a public offering. It was pointed out in these decisions that the subsequent seller could not rely on a claim of a private offering exemption unless he had full knowledge of the identity and number of the original offerees and purchasers and their intent with respect to subsequent sales of the securities to others. The Commission concluded that the situation was one involving the purchase of unregistered convertible debentures from the issuer with a view to selling some of them immediately to a few friends and associates and making further sales if the issuer's prospects turned out to be less favorable than anticipated.[30] Such conclusion was based on the fact that the sales were in fact made.

In the *Dempsey* case,[31] the contention was made that the subsequent redistribution amounted in substance to subdividing an investment opportunity rather than making a distribution. In rejecting this view the Commission stated:

We cannot agree with registrant's position. In our opinion, despite the fact that registrant's sales prior to June 19, 1956 did not give the appearance of a conventional distribution to the public, registrant bought securities from the issuer with a view to distribution and thereby became an underwriter within the meaning of the Securities Act. It is undisputed that at the time registrant acquired debentures from Crowell-Collier, it intended to resell some of the debentures to certain relatives, friends and associates of Dempsey. Respondents' willingness to make subsequent sales upon request indicates, and under all the circumstances we conclude, that subsequent sales were also within respondents' contemplation at the time of registrant's purchases from Crowell-Collier.[32]

In June 1961, the Commission in *Hazel Bishop, Inc.*[33] was faced with a situation where 562,500 shares were sold in what were claimed to be exempt transactions. The Commission on reviewing the facts, however, found that although the shares were issued to and would remain in the names of thirty-two persons, there had been a substantial redistribution of the beneficial ownership.

[A]lthough those shares were nominally issued to and still remain in the names of 32 persons who gave investment letters and acquired certificates stamped with a legend restricting resale, pledge or hypothecation, the record shows that the purchasers in many instances acquired shares on behalf of numerous other purchasers or entered into arrangements with others concurrently with or immediately after

30. SEC Securities Act Release No. 3825, at 5-8, Aug. 12, 1957.
31. 38 S.E.C. 371 (1958).
32. Id. at 375.
33. SEC Securities Act Release No. 4371, June 7, 1961.

their purportedly restricted purchases whereby the latter acquired beneficial ownership of some of the stock involved. In most of such cases the nonrecord purchasers apparently paid for the shares allocated to them without obtaining any document of ownership or written evidence of the obligation of the seller. Some of the arrangements provided for profit sharing between the seller and buyer and guaranties against loss by the seller, and in one case the shares purchased from registrant were pledged with a factor who advanced the funds for the purchase under an agreement that it would share in the profits of the ultimate sale of the shares by the pledgor. By these means a wide group of persons who were not in a position to have, and were not supplied with, the information which a registration statement would have supplied them to make an informed investment judgment with respect to registrant's stock were sold a variety of interests in unregistered stock.[34]

The Commission made reference to transactions involving three original purchasers, which after various subdivisions of interest, resulted in eighty-five additional persons acquiring beneficial interests in 101,550 shares out of the 117,000 shares issued by the registrant to the three persons in question.[35]

When reviewing the record as a whole, the Commission found that section 5 of the act[36] had been violated and that the registrant became contingently liable under section 12(1)[37] to purchasers of such shares for rescission or damages.

34. Id. at 13-14.

35. The Commision went on to say: "In addition to the shares discussed above, 15,375 shares of registrant's common stock not covered by the registration statement were issued to eight officers and employees of registrant in December, 1959, upon exercise by them of options. Each of those persons furnished registrant with an 'investment letter' but all of such shares of stock were sold to the public on the open market during 1960. It is clear from the foregoing that a widespread public distribution in violation of Section 5 of the Securities Act was effected with respect to the shares issued by registrant in 1959 and 1960 and those sold by Spector in the same period. The registration statement states that the 562,500 shares issued by the registrant in the December, 1959-April, 1960 period were acquired by a limited group of sophisticated and informed persons knowledgeable in its affairs. However, despite the ostensible limitations to a small number of purchasers acquiring substantial blocks of stock on a restricted investment basis and purportedly qualifying the issue for an exemption as a private offering, large sums were in fact raised for registrant as a result of sales to a large number of smaller public investors in advance of and without the safeguards provided by registration. The device of obtaining investment letters and providing that persons acquiring interest in such stock would not effect transfers or pledges until after registration could not operate to eliminate the necessity for registration. It is obvious that such investment letters and restrictions are meaningless when given by persons who have already transferred to others the beneficial interests in part or all of the shares they are acquiring or who simultaneously or shortly thereafter arrange to sell to others or share in the profits on resale by others or dispose of their shares on the open market. In the light of established principles and published interpretations, there could be no doubt that a public distribution was being effected and that the purchasers from registrant and from Spector who made divisions of their interests or other dispositive arrangements with respect thereto or sold shares on the open market were statutory underwriters in connection with such public distribution." Ibid.

36. 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e (1958).

37. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77l (1958); see note 3 supra.

Changes In Circumstances—When Do They Afford A Basis For Resale?

Assuming that the various factors warrant the conclusion that shares have been acquired in good faith for investment and not for distribution, it is not necessary that these shares be held for an indeterminate length of time. The law does not freeze the purchaser. Obviously, the longer the shares have been held, the greater the credence that can be given to the representation that they were acquired for investment and not for distribution. On the other hand, a more immediate sale may be permissible if there have occurred such changes in circumstances as would, in effect, not negate the original representation that the acquisition had been for investment purposes. Such changes would relate to holders of the securities or to the company itself.

In considering the point at which investment stock can be resold, one again enters a field of vagaries where the question can be resolved only by weighing a number of factors.

One of these factors would be the general activity in which the holder of the shares is engaged. As pointed out in an opinion of the General Counsel in 1938,[38] it would be far easier for an insurance company or an investment company to sustain the burden of proof that they had purchased for investment than it would be for a dealer or an investment banking house whose principal occupation is the purchase and sale of securities. The true criteria, it would appear, is whether the change of circumstance is such that the original representation that the stock was being acquired for investment purposes would still be entitled to full credence.

Although the General Counsel had expressed the view that the retention of the securities for as long as a year would create a strong inference that they had been purchased for investment, he made it clear that such an inference would be rebutted by any prearranged plans for a distribution.[39] Thus, the mere retention for a year would not of itself be sufficient to foreclose the purchaser from being considered as an underwriter. In the *Crowell-Collier* case, the Commission stated in this connection:

> Holding for the six months' capital gains period of the tax statutes, holding in an "investment account" rather than a "trading account," holding for a deferred sale, holding for a market rise, holding for a sale if the market does not rise, or holding for a year, does not afford a statutory basis for an exemption and therefore does not provide an adequate basis on which counsel may give opinions or businessmen rely in selling securities without registration.
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> Purchasing for the purpose of future sale is nonetheless purchasing for sale and, if

38. Op. Gen. Counsel, SEC Securities Act Release No. 1862, at 2, Dec. 14, 1938.
39. Ibid.

the transactions involve any public offering even at some future date, the registration provisions apply unless at the time of the public offering an exemption is available.[40]

On the other hand, in *United States v. Sherwood*,[41] the district court held that the passage of two years before the commencement of distribution was an "insuperable obstacle" to a finding that the shares were taken with a view to distribution in the absence of contrary relevant evidence. The court seemed to feel that a two-year holding was almost conclusive evidence.

In most of the reported cases the changes in circumstances were considered to be an insufficient basis for the claim of exemption.[42] What circumstances would furnish adequate justification to permit a holder of investment stock to sell shares without registration? A few guideposts may be suggested:

First, was the change of circumstance foreseeable; did the holder create it or should the purchaser, as a reasonably prudent man, have anticipated it? If the stockholder created the change in circumstances, he cannot be heard to urge it as a justification for a sale. If the stockholder could reasonably have foreseen the change of circumstances, the courts would hold that having acquired the stock with the knowledge that circumstances would change, the stockholder could not then use the same change to justify the selling of the shares. A stockholder who had acquired stock one year previously, knowing at that time that he would have to sell the stock in order to raise funds for his son's education, could not justify the sale on the ground that he now needed the money for the education. Similarly, as indeed the court held in the *Crowell-Collier* case, a rise or a fall in the market is not sufficient change of circumstances, since a claim that stock was acquired for investment would imply a longer term investment, not to be governed by the fluctuations in the market price of those particular shares. Another such situation would exist where a stockholder purchased investment stock and then, after a substantial rise in its price, claimed that it was necessary to sell it in order to diversify his investments. The mere assertion of such a claim would indicate that he actually intended to sell all or part of these shares if there was a substantial accretion in their value. The prudent stockholder should realize that if his investment turns out favorably, he obviously will have a substantial commitment in the stock which he purchased. The failure of a company to increase a dividend where the market price of the stock had doubled in nine months, which

40. SEC Securities Act Release No. 3825, at 7-8, Aug. 12, 1957.

41. 175 F. Supp. 480, 483 (S.D.N.Y. 1959) (involving a motion to punish for criminal contempt which would require evidence beyond a reasonable doubt).

42. See Cohen, Federal Legislation Affecting the Public Offering of Securities, 28 Geo. Wash. L. Rev. 119, 142 (1959).

obviously resulted in a decrease of yield, was held by the Commission staff to be inadequate.[43]

Cases where change of circumstances would furnish a valid basis for exemption would be those where the change would not have been reasonably anticipated and where the change was so material in character, that to sell the stock in the light of such a change would not negate the basis for the original claim of exemption of investment acquisition. Perhaps the clearest case would be one of sudden and severe illness to the investor or to his family. Another such case would be unanticipated financial reverses to the extent that it was necessary for the shareholder to reorganize his holdings and to liquidate a substantial part thereof. Of course, if the stockholder had many other investments, the sale of which did not in any way involve an exemption problem, it would be desirable for him, from a legal viewpoint, to liquidate his clearly available holdings before he had recourse to the problematical stock, or at least to liquidate all of his holdings on a pro rata basis.

There are many other situations where it would be reasonably clear that the subsequent sale of investment stock did not negate the validity of the original representation of investment. Such a situation would exist where a stockholder's employment had terminated and he was required to arrange for some new employment or to move to some other part of the country, so that he would no longer be in a position to maintain his interests in the original company. A stockholder might accept a government position which would require him to divest himself of certain holdings either because of potential conflicts of interest or to supplement a lower salary. Where, because of some development in the company's affairs, the prevailing conditions become radically different from those contemplated by the stockholder at the time of the purchase of the stock, the stockholder could sell his shares. In another situation, a company, in which a stockholder has invested, may be pursuing one line of business activity, but subsequently merge with another company so that it becomes an essentially different enterprise from that originally contemplated. Another situation which might be mentioned would exist where a stockholder has a material interest in one company which he purchased for investment, but he thereafter becomes interested in another company, or in another position, which would require him to divest himself of the stock of the first company in order to avoid a conflict of interests.

At the present time there is little case law involving the above situations, and hence the answer in a given situation will depend upon the particular facts. In due time, judicial precedents will be established which will serve as guide posts in this field.

43. Id. at 143.

Recently, in *SEC v. Guild Films Co.*,[44] the Court of Appeals for the Second Circuit had occasion to pass upon the question of a bank selling unregistered stock which had been deposited as a security for a loan. The stock in question was issued under an agreement that it was being acquired for investment only and not for the purpose of distribution or further sales. The certificate bore a notation to the effect that the shares were not registered and that they could not be transferred, pledged, or hypothecated in the absence of an effective registration statement or of an opinion of counsel to the company to the effect that registration was not required under the Securities Act. The stock was used as collateral for a loan, and after the loan was in default, the bank attempted to sell the securities through brokers on the American Stock Exchange. The transfer agent refused to transfer the stock and the bank brought action in the New York Supreme Court to compel transfer of the stock. The court, relying on the report of a referee, which found the stock transfer to be exempt from the Securities Act, ordered the transfer of the stock to the bank.[45] The Securities and Exchange Commission then filed suit to restrain the delivery of the shares. The district court granted a preliminary injunction[46] which was affirmed by the court of appeals.[47] The latter court pointed out that, although the bank did not purchase the stock, it did acquire it with knowledge that it might have to resell it.[48] It was pointed out that Congress had refused to insert in the act a proposed exemption for sales of securities pledged as collateral.[49] The court found that regardless of any question of "good faith" the bank could not sell it, since it knew that they had been given unregistered stock and that they should have known that "immediate sale was almost inevitable if they were to recoup their loans. . . ."[50]

APPLICABILITY OF BROKERAGE EXEMPTION

In addition to the exemption provided for in section 4(1), there is an exemption in section 4(2)[51] relating to broker's transactions executed in the open or counter market but not relating to the solicitation of such orders. However, this exemption has been construed as applying only to the broker's part of the transaction so that an issuer making

44. 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960). For criticism of dicta in the case concerning the status of a bona fide pledgee who acquired shares without expectation of resale or foreclosure, see 1 Loss, Securities Regulation 645-51 (2d ed. 1961).
45. Santa Monica Bank v. Guild Films Co., No. 11185 (N.Y. Sup. Ct., Aug. 19, 1959).
46. 178 F. Supp. 418 (S.D.N.Y. 1959).
47. 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960).
48. 279 F.2d at 490.
49. Id. at 489.
50. Id. at 490.
51. 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1958); see note 4 supra.

a distribution through a broker is not thereby relieved of the registration requirements of the act.[52] If a sale is part of a public distribution, the fact that it is accomplished through a broker's transaction will not support an exemption.

Similarly, rule 154 of the Commission,[53] which contains a statement that the term "distribution" is not deemed to include certain limited sales made by controlling persons, would not be the basis of an exemption for subsequent transfers of investment stock. In *Skiatron Electronics & Television Corp.*[54] the Commission stated as follows:

It is equally clear that Rule 154 did not cover Levey's sales. That Rule defines certain terms in connection with the exemption in Section 4(2) of the Act for certain "brokers' transactions." The Rule itself provides no exemption for an issuer or a controlling person of an issuer, but merely sets out certain standards as aids in determining when transactions by brokers are routine trading transactions within the brokers' exemption of Section 4(2), and when such transactions may be part of a distribution of securities by broker's principal and not exempt as "brokers' transactions." The Rule does not furnish an exemption even for the broker when he is aware of circumstances indicating that his principal is engaged in a distribution of securities. *A fortiori*, it furnishes no basis for a claim of exemption by the principal who is making a public distribution of securities.[55]

WHO CAN BE HURT?

Assuming that investment stock is transferred without registration and that the original exemption cannot be supported, who would stand to lose? In the first place, the seller of the stock violates section 5 of the act by selling unregistered stock, so that the transaction is subject to recision or the seller is liable for damages. This liability, covered by section 12(1) is virtually absolute. The only practical defense in such cases would be the establishment of some exemption. Where the exemption cannot be supported, the seller becomes liable irrespective of any intention on his part to violate the act and irrespective of any knowledge of the violation.

The term "seller" would also appear to include a broker who is the agent of the seller and this would probably encompass agents, who themselves might have been unaware of the fact that the stock was not exempt. The cases are in conflict as to the extent of the liability of persons not technically agents of a seller but yet active participants in the sale.[56]

52. SEC Securities Act Release No. 131, March 13, 1934.

53. 17 C.F.R. § 230.154 (1954).

54. SEC Securities Act Release No. 4282, Oct. 3, 1960.

55. Id. at 12.

56. See 3 Loss, Securities Regulation 1717 (2d ed. 1961). Compare McClain v. Bules, 275 F.2d 431 (8th Cir. 1960) and Wall v. Wagner, 125 F. Supp. 854 (D. Neb. 1954), aff'd sub nom. Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955), with Zachman v. Erwin, 186 F. Supp. 681 (S.D. Tex. 1959).

Section 15 of the act also provides for liability of controlling persons but, in that section, there is a defense based on lack of knowledge of the facts on which the liability is predicated.[57]

The status of the original issuer of securities purported to have been sold in a private transaction but subsequently found to have been in fact a public offering is not wholly clear. The wording of section 12 relates to the "seller." Initially, therefore, only the stockholder who had resold the shares would be liable. In a case, however, where the plaintiff could show that there had been a plan of distribution, the actual selling stockholder would be deemed to be an underwriter because he had purchased from an issuer with a view toward distribution. In this way, the transaction might be considered as one transaction with the original issuer being considered as the seller.

The recent case of *SEC v. Mono-Kearsarge Consol. Mining Co.*,[58] involved the issuance of an injunction against sales and transfers by the SEC. Although civil liability was not immediately involved, much of the court's language could be used to support civil liability on the basis that the corporation in fact contemplated or acquiesced in a subsequent public redistribution.[59] The court found that the corporation knew that a public distribution was being accomplished through subsequent sales of so-called investment stock because of its subsequent handling of the stock for transfer purposes.

Much less was Mono-Kearsarge in a position to rely upon the investment theory when its understanding at the crucial time of the transfer was that the stock was not being taken by the recipients solely for investment purposes and *when its own words and actions, including its subsequent handling of the stock for transfer purposes,*

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57. "Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77o (1958).

58. 167 F. Supp. 248 (D. Utah 1958).

59. In discussing the actions of the dealers, Jean R. Veditz Co. and R. B. Gravis, Inc., the court stated: "Veditz and Gravis contend that . . . they did not know of the controlling or controlled position. The defendants are held to have knowledge of those facts which they could obtain upon reasonable inquiry. Probably the facts directly known by them were sufficient to acquaint them with the true situation. If not, they were sufficient to impose upon them the duty of making further inquiry. Under the circumstances, they were not entitled to rely solely on the self-serving statements of . . . [those] denying those facts which would have indicated that they were representing controlling persons, or were under common control with an issuer. With all these red flags warning the dealer to go slowly, he cannot with impunity ignore them and rush blindly on to reap a quick profit." Id. at 259.

reasonably indicated that the corporation understood a public distribution was being accomplished.[60]

The *Mono-Kearsarge* case involved a so-called investment block of 250,000 shares issued on December 10, 1957. In April 1958, the transfer agent of the corporation refused to transfer certificates from this block on the ground that they constituted investment stock and were marked as such. However, the transfer agent did not refuse to transfer another block, also claimed to be investment stock but not marked as such, and the court held that in effect the acquiescence of the corporation in the transfer of the latter block indicated that the corporation understood that a public distribution was in fact being accomplished. The distributors also contended that they were dealers and not underwriters, but the court held them to be underwriters. Finally, it is to be noted, that the seller had secured a letter from an attorney saying that the transactions were exempt from Section 5 of the Securities Act but this was held to offer no justification for the violation.[61]

The *Mono-Kearsarge* case illustrates the dilemma which may confront issuers in the policing of transfers. This dilemma was also demonstrated in *Guild Films Co.*,[62] where the New York Supreme Court had ordered the transfer of the securities only to have the transfer enjoined by the federal district court in a suit on behalf of the Commission. Normally a corporation is obligated to register transfers on demand unless any restriction on transfer is noted on the security. Of course, a purchaser having knowledge of restrictions contained in an investment letter has taken the security with knowledge of its limited transferability so that he would probably be bound thereunder, and the issuer would probably be justified in refusing to transfer the certificate.[63] This would not, however, apply to a bona fide purchaser for value who did not know of the limitations.[64] In such a case, the issuer faces a risk regardless of which course he pursues. There may be liability for violation of the Securities Act on the one hand, and on the other there may be liability to a purchaser for refusal to transfer the certificates.

In addition to the seller, agent or broker for the sale, and the issuer, other participants as well may be potentially liable. Under the theory of integration—the basis upon which the Commission holds that an exemption destroyed in part is destroyed in whole[65]—a resale by one

60. Id. at 255. (Emphasis added.)

61. Despite this letter, the court held that the sellers "proceeded at their peril as underwriters by reason of having purchased from controlling persons with a view toward distribution to the public." Id. at 259.

62. SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960).

63. See N.Y. Pers. Prop. Law § 176.

64. N.Y. Pers. Prop. Law § 168.

65. Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825, Aug. 12,

member of the purchasing group may destroy the exemption and thus create potential liability for all under section 12. This might be technically true even where the other participants had no knowledge of the misstated intent of one of their number.[66] Likewise, under a strict construction of the act, the destruction of the exemption by the improper act of one purchaser would apparently not only destroy the exemption for the entire group but also result in liability to the issuer itself.

Some Suggestions

When counsel is called upon for advice in connection with the issuance of investment stock, the first precaution would be to assure that the purchaser sign a proper investment letter. Some investment letters merely state that the stock is being purchased for investment and not for distribution. Prudent counsel, however, may wish to insert in the investment letter a further representation that the purchaser has the financial means to acquire and retain the stock as an investment and that he knows of no present situation which in the foreseeable future will require the liquidation of the shares being so purchased. In cases where institutions are the purchasers they should be asked to represent that they are properly authorized by their charter to acquire the holdings in question and that there are no limitations in their charters or in any governing article or agreements, such as loan agreements or, in the case of regulated investment companies, the statement of fundamental policy, restricting their investment, which would conflict with their power to acquire and hold the investment shares. In some cases, it may be helpful to have an agreement under which a person acquiring stock for investment will agree with the issuer that the stock will first be reoffered to the issuer or to other stockholders on a pro rata basis before it can be transferred to third persons. The existence of such an agreement would not, of course, validate a subsequent transfer where it might otherwise be improper, but it would serve to give the issuer and the other stockholders a larger measure of control over transfers and would also protect them against retransfers by subsequent tansferees.

When the certificates for the shares are issued, they should be issued in the actual names of the holders and not in street names or in the names of nominees. The certificates should bear a notation to the effect that the shares represented thereby are being issued as investment stock

1957; Herbert R. May, 27 S.E.C. 814, 819-20 (1948); 1 Loss, Securities Regulation 687-89 (2d ed. 1961).

66. But see Gilligan, Will & Co., 267 F.2d 461, 467 (2d Cir. 1959), where the court of appeals indicated by way of dictum that the establishment of a "reasonable and bona fide belief" on the part of the sellers as to the total number of persons involved in the placement might be sufficient to support the exemption.

and not for public distribution and that such shares may not be transferred without a satisfactory legal opinion that the subsequent transfer does not violate any provisions of the Securities Act. Finally, since it is possible to transfer beneficial interests in stock without a transfer of the certificate itself, the certificate must contain some statement to the effect that not only are the shares represented by the certificate limited in their transferability, but that the same is true of the beneficial interests in the shares.

In view of the potential liability of other participants in the private offering and of the issuer itself in the event of a retroactive loss of exemption brought about through the misstatement of intent by one of the purchasers, consideration should be given to cross indemnification agreements under which the various innocent participants would be protected.

In a number of recent private placements, covenants have been made by the issuer that the shares in question would be registered either upon demand of a certain number of their holders or in connection with some subsequent public financing. In this connection, the promulgation of rule 152[67] under the Securities Act has been particularly helpful as it makes the integration rule inapplicable in the event of a subsequent public offering or the filing of a registration statement.[68]

If there is reasonable doubt as to the propriety of a subsequent sale or transfer, a request can be made to the Commission for a "no-action letter."[69] In case the stockholder desiring to sell the shares submits all the facts to counsel for the Commission requesting a "no-action letter," it is to be noted that even this will not afford complete protection against the possibility of civil liability. The effect of such a letter is merely to indicate that the Commission staff will not take action under its own enforcement powers. As a practical matter, however, such a letter based on full disclosure of all the facts would appear to offer reasonable protection.

After it has been concluded that a sale is proper, the wise seller will make some attempt to supply the purchaser with as much information as possible concerning the issuer. He will bear in mind the test enunciated

67. 17 C.F.R. § 230.152 (1949).

68. "The phrase 'transactions by an issuer not involving any public offering' in section 4(1) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." Ibid.

69. A "no action letter" is one obtained from the Corporate Finance Division of the Securities and Exchange Commission stating that on the basis of the facts presented that division would not be disposed to take any action if the proposed transaction were carried out, or words to that effect. Victor & Bedrick, Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869, 872-73 (1959).

in the *Ralston Purina*[70] case—that one of the criteria relating to the exemption is the availability of information to the purchaser. In a case where a registration statement may already be in effect with respect to certain securites of an issuer, a seller of unregistered securities could deliver a copy of the prospectus to the purchaser even though the particular shares in question were not covered under the registration statement. Where no such prospectus is available, it is suggested that if possible, similar information be furnished to the prospective purchaser.

CONCLUSION

It is clear from the case law that investment letters must be approached with considerable caution. Obviously the mere existence of a written letter signed by the purchaser will not be sufficient. The validity of a transaction will be judged upon a review of all the facts and there inevitably will be a serious assumption of risk involved unless investment letters can be in fact supported by the facts.

While the past few years have brought about an increasing number of rules and decisions which serve as helpful guides, it is believed that experience and time have reached the point where more definite rules should be enunciated, either by amending the Securities Act, or preferably through the more flexible method of promulgating pertinent regulations. The latter method would not only clarify some of the points which are now obscure but would also offer a greater measure of protection to persons acting in good faith.[71]

70. 346 U.S. 119 (1953).

71. Victor & Bedrick, Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869, 882-83 (1959), sets forth the following proposals: "(a) Provide unequivocally that a seller who relies in good faith upon an investment covenant will not be subject to Securities Act liability. In other words, give the seller the clear right to rely on the signed covenant the way a bank in good faith is permitted to rely on its borrower's signed statement that the loan is not for the purpose of carrying a listed security. (b) Provide that any offering to 100 or less persons is, as far as the seller is concerned, exempt from the Securities Act if each purchaser signs an investment covenant unless the seller has reason to believe that any one of the purchasers will attempt to resell within two years. In this connection, provide that where securities dealers are involved, the seller will have no obligation to inquire (beyond the investment covenant) so long as the dealer is a member of NASD. (c) Provide that an employee option holder who signs an investment covenant in good faith shall be free to sell after one year without incurring Securities Act liability. (d) Provide that all other purchasers who sign an investment covenant in good faith may sell after two years. (e) Provide that reliance upon a 'no action' letter shall exculpate an issuer and seller from Security Act liability if the factual assumptions upon which such ruling was rendered are substantiated. (f) Provide that all sales to banks, insurance companies, pension or profit sharing trusts, or other institutional buyers constitute exempt transactions within section 4."